

**TESTIMONY BEFORE THE PRESIDENT'S
COMMISSION ON THE POSTAL SERVICE**

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Chairmen Pearce and Johnson, members of the Commission.

Thank you for inviting me to testify. I am encouraged that a consensus appears to be forming that this nation needs to take action to insure that it continues to benefit from a healthy and effective Postal Service.

For more than 200 years, the post has played a major role in tying together our vast country. Modern technology is certain to change the role of the Postal Service in the coming years, but if we plan wisely, the Postal Service can and should continue to be an important communication link for both businesses and private citizens.

This Administration is to be commended for recognizing the growing need before a crisis exists. It is also to be commended for gathering such a qualified group of individuals to grapple with the complex issues involved in developing a sound structure for a 21st century Postal Service.

As a member of the Postal Rate Commission, I have become very aware of the many competing factors that must be balanced in making postal policy. I hope I can offer some useful perspective.

I believe the topics to be addressed by your subcommittees cover the most important problems facing the Postal Service today. My particular expertise directly relates to areas being explored by the Business Model Subcommittee and the Private-Sector Partnership Subcommittee. The current rate regulatory system impacts most aspects of your inquiries in both of these broad areas.

This morning I will focus on four topics.

First, I will discuss why the current process for setting postal rates has evolved into its current form.

Second, I will discuss how the current process for setting postal rates achieves its statutory purposes.

Third, I will discuss the pricing principles currently applied by the Postal Rate Commission and why those principles have been viewed as appropriate for today's Postal Service.

Before closing, I will identify areas where the current ratemaking process could be improved, and explain how and why changes in these areas would strengthen the current system.

I. Why the Current Process was Established.

The first step in evaluating possible changes to the Postal Service is understanding the factors that caused the existing system to take its current form. Any discussion of pricing postal products must start with recognition that the Postal Service is a huge and powerful government monopoly.

By law, only the Postal Service may deliver letters. Essentially, that means only the Postal Service may act as a third party to deliver written communications between Americans, although administrative regulations currently provide limited exceptions, such as the one for urgent documents.

Furthermore, only the Postal Service may access an individual's mailbox.

As a result of these restrictions, the Postal Service has enormous market power. The Postal Service writes the regulations that control access to its network, and its actions can have tremendous impact on the

private sector. Most businesses must constantly strive to please their customers. In contrast, many mailers have nowhere else to go, and often have to strive to please their supplier.

It has been said that the power to tax is the power to destroy. A close corollary is that a monopolist that can set its own rates for essential services has the ability to cause great harm. This is particularly so when the monopolist provides services in competitive markets as well as its monopoly products.

I am not suggesting any past, present, or future intent by the Postal Service to compete unfairly or to provide unjustifiable preferences as between particular members of the business community. I simply point out that because of its legal monopoly, decisions by the Postal Service can have a devastating impact on diverse segments of the American economy. The Service has the power to severely hamper the ability of individual firms to compete in the marketplace, or private citizens to communicate with family, friends, or businesses.

The Postal Reorganization Act of 1970 attempted to fashion a system that provided protections for all American mail users. It recognized that the Postal Service needed to operate in a more businesslike fashion than it had when it existed as a Cabinet department. At the same time, it recognized

that a government monopoly providing vital services to the nation should not be given carte blanche.

A review of the Reorganization Act of 1970 indicates that with regards to the pricing of postal products, Congress had three goals in mind. It wanted to assure the continuing fiscal stability of the Postal Service without burdening taxpayers; it wanted to assure that rates would remain reasonable, while sufficient to support efficient and economical operations; and it wanted to establish a system under which rates would be fair to all affected persons, and free from undue discrimination.

I suggest those goals remain appropriate even as we change to meet new circumstances.

Today new forms of electronic communications present alternatives to the letter. As a result, the current business model of the Postal Service may shortly become obsolete.

That business model assumes an ever-increasing volume of captive, high value letter mail, able and willing to pay whatever is necessary to maintain prompt and reliable universal service. Now, the prospect of losing a substantial portion of First-Class volume to faster, more reliable, and less expensive alternatives threatens the viability of that model.

As your Commission explores ways to adjust to meet new circumstances, I suggest that since the three goals of Congress in 1970 remain important considerations, change in the pricing area may not need to be as radical as some observers seem to think.

Communications is a vibrant, expanding market. The telephone did not kill the Postal Service even though it may have surpassed it in terms of total volume of communications.

The ever-expanding number of addresses, which the Postal Service often cites as generating increasing costs, also may be the most valuable foundation for maintaining the financial viability of the Service. Each new business and residence needs and generates mail, and the Postal Service has unparalleled expertise in linking new businesses into the nationwide infrastructure for hardcopy communications.

Furthermore, large numbers of individuals and businesses will remain captive customers, and these customers must be protected from exploitation.

In particular, several segments of the American economy that have traditionally been highly dependent on the existence of a healthy and

reliable postal service still will be without ready alternatives. Small businesses and professional offices need an effective means to reach customers that can neither afford nor operate computers. Publications, from small local newspapers to large national magazines, depend on the Postal Service to deliver their product. And approximately 20 percent of expenditures for the advertising that fuels this nation's great economic engine are delivered in the mail.

When Congress was contemplating postal reform in 1970, it was concerned that postal management might succumb to pressure from large advertising mailers in setting rates. Congress recognized that there would be a strong temptation to shift most of the rate burden on to captive First-Class Mail users.

It responded to these concerns by establishing an independent, expert agency to assure that postal rates were fair and reasonable.

Postal management would not be allowed to increase rates on captive customers unless it could justify the need for the additional funds in an open, public process. An independent body would hear from any interested person and evaluate all evidence and arguments before rates allocating the costs of postal operations were changed.

There are numerous indications that this process has provided precisely the type of protections Congress considered necessary. The PRC has restrained the Postal Service from shifting overhead cost to captive First-Class mailers. In four of the ten contested omnibus rate cases the PRC has reduced the requested price for the single piece letter stamp. Small businesses that have been unsuccessful in getting heard by the postal bureaucracy have easily and inexpensively been able to have their concerns recognized during the independent review process.

Finally, the existence of an independent, expert agency has eased fears that the Postal Service was cross-subsidizing its competitive products with monopoly revenues. The PRC has assured that the costs of providing all services are accurately traced, and that rates for each competitive product provides a reasonable level of contribution towards the institutional costs of the Postal Service. This outside review has preserved a generally level playing field despite the potential for monopoly exploitation.

II. How the Current Process Works.

In some ways, the process for setting postal rates may appear similar to those applicable to many public utilities, but it has several important, unique aspects.

This process was designed as an attempt to balance three potentially conflicting goals. First, Congress wanted to ensure that the mail would generate sufficient revenues so that the Postal Service would always meet its payroll and other expenses.

Second, Congress wanted postal rates to be reasonable, so it directed the Postal Service to operate efficiently, and required it to publicly justify rate increases. Third, it wanted postal rates to be fair to all categories of mail users. Congress attempted to balance these goals though limitations on the authority of both postal management and the independent ratemaking agency.

The most obviously unique aspect of postal ratemaking is that the Postal Rate Commission does not set rates in the traditional sense. It recommends rates to the Postal Service Governors who can approve or reject those recommendations. Under a limited set of circumstances, the Governors may even modify a PRC recommendation.

In practice, the PRC's recommendations generally become the new rates. Court review of new rates is available to all participants appearing before the PRC, including the Postal Service. If an appeal is taken, the PRC's explanation of its findings and the rationales underlying the recommended rates is reviewed by a United States Circuit Court of

Appeals. The Supreme Court has addressed issues concerning the responsibilities of the PRC once, in National Association of Greeting Card Publishers v. United States Postal Service. 462 U.S. 810 (1983).

Another unusual aspect of the current postal ratemaking process is the treatment of the revenue requirement. Private utilities seeking rate increases must justify their need for additional funds, and regulators may exclude projected expenses considered to be inappropriate. In common parlance the regulator sets the revenue requirement.

The PRC does not set the revenue requirement for the Postal Service. The current law directs the PRC to recommend rates sufficient to provide the funds that the Postal Service expects to need. The Commission corrects misestimates, but it may not exclude as improvident, funds for initiatives postal management commits to undertaking.

These two unique aspects of the ratemaking process are designed to assure that mail rates generate sufficient income. However, many contend that they also have frustrated the goal that rates be reasonable.

The argument is that an organization that knows it will be reimbursed for any expenditure it makes will not be sufficiently motivated to operate efficiently, or to avoid imprudent or wasteful expenditures.

In theory, regulators act as a proxy for the discipline imposed by competitive market forces by controlling the revenue requirement of public utilities. In the postal area, Congress chose not to impose that check on management. But many mailers contend that as a consequence, inefficient practices are allowed that boost the cost of postage to the mailing public.

This conflict is most clearly seen in the implementation of the clause in the current law that makes a provision for contingencies part of the Postal Service's revenue requirement. The Postal Service believes that this allows it to add any amount for contingencies to its demonstrated revenue needs. Mailers have contended that the Service should have to show that the amount it wants for contingencies is reasonable, and to account for how these funds have been spent.

This is an area that the President's Commission may well wish to clarify.

The goal that rates be fair has been met in two principal ways. The current law requires that rates be set so that the revenues from every subclass of mail are high enough to recover the cost of providing service to that subclass. This assures economic fairness; that is, the absence of

cross-subsidies. The law also requires that rates be established in an open public process, with the justification provided for all decisions.

The Postal Reorganization Act directs that postal rate cases be conducted subject to the requirements of the Administrative Procedure Act. A description of the procedural steps in postal rate cases was provided to this Commission. It can be found at Tab 4 in the Briefing Binder provided by the Postal Rate Commission to each member of the President's Commission on the U.S. Postal Service.

The APA establishes a set of guidelines to ensure that due process is provided to all persons wishing to participate in the ratemaking process. In the Ratemaking Summit convened jointly by the Postal Service and the PRC last summer, there was broad consensus among the mailing community that the PRC's current process provides the necessary and desirable levels of due process notwithstanding the tight deadlines applicable in postal rate cases.

Before leaving this topic I want to touch on two other matters: the amount of time it takes to change rates, and the flexibility of the current system.

The time necessary to litigate a rate case has been a source of concern from the outset, and in 1976 Congress amended the law to allow the Postal Service to implement rate changes on a temporary basis if the PRC did not act on any rate request within 10 months. The 10-month period was designed to provide due process to all affected interests. Since that amendment, the PRC has acted in 10 months or less in every case. It has also shown itself willing and able to respond to extraordinary circumstances, as when it facilitated a prompt settlement of the rate request overtaken by reaction to the anthrax scares and the September 11th terrorist attack.

The current law provides the PRC with the authority to hear and recommend a wide variety of rate and service initiatives. The system may appear limited largely because only the Postal Service may initiate changes involving rates. The PRC has repeatedly expressed the view that if properly supported, concepts such as phased rates and negotiated service agreements were lawful, and it has adopted procedural rules to facilitate requests for experiments. In practice, it has been the Postal Service that has resisted changing the traditional omnibus rate case model or actually proposing new services or rate concepts.

The current system assures that there is justification before rate increases are imposed. It also assures that affected interests are heard in

a timely manner. The Postal Service's ability to understand its costs, and react to them, has improved vastly as a result of the discipline of public rate cases. I believe this system continues to serve the nation well.

III. Current Ratemaking Principles.

The touchstone of postal ratemaking since the Reorganization Act of 1970 has been cost-based rates. The Reorganization Act established only one rate policy as a requirement — that the rates for each class of mail recover the direct and indirect costs of providing service to that class.

Cost-based ratemaking focuses attention on the types and amounts of costs the Postal Service incurs. Mailers know their rates will increase if the Service processes their mail inefficiently, and therefore they scrutinize past and projected expenses. The recent Postal Service focus on restraining the cost of processing flats (magazines and similar shaped pieces) is a direct result of mailer agitation because skyrocketing costs in this area were causing disproportionate rate increases.

Postal costs have been extensively analyzed before the PRC by the Service, mail users, and competitors, to assure that all costs are correctly associated with the classes of mail that cause them. This process is

continuous, as new operational practices and technologies change cost incurrence patterns. Attributing costs to mail classes and subclasses is the first step in postal ratemaking.

Costs that can not be attributed are considered institutional, and distributed on the basis of policy factors enumerated in the Act. Here again, rate proceedings offer affected persons the opportunity to present evidence justifying suggested allocation shares. Rates in each subclass are then designed to generate needed revenues.

The signal achievement of ratemaking since the Reorganization Act has been the development and extension of worksharing principles. This has been a cooperative effort by the mailers, the Postal Service, and the PRC. While industrialized countries around the world struggle with how to bring the benefits of competition to the postal sector, we in the United States have made significant strides toward achieving that goal through worksharing.

Worksharing recognizes the benefits of allowing the lowest cost provider to do work. In the postal sector it involves offering discounts to mailers that choose to prepare their mail in a manner that reduces costs for the Postal Service. This most frequently entails presorting mail and/or delivering it directly to facilities that perform delivery sortation.

As a result, new highly competitive industries have developed to presort mail for businesses and to consolidate mail for shipment to downstream Postal Service processing facilities. Today, more than 25 percent of the value chain of postal operations is performed by the private sector, and this figure should continue to grow, making the end-to-end cost of sending mail even more economical.

Worksharing discounts are set using the principle of “efficient component pricing.” Under this system, the discount for any activity is set to allow the lowest cost provider to do work. For example, the discount for a particular sortation procedure is set at what it costs the Postal Service to perform that step. If a mailer can do the work less expensively than the Postal Service, it will do so and keep the difference. This provides incentives to both postal labor and postal management to perform efficiently. If they are inefficient, work will leave the system, and their services may no longer be required.

A salutary aspect of efficient component pricing is that no other mailer is disadvantaged when discounts are provided. Because discounts are limited to actual costs avoided by the Postal Service, the contribution to institutional costs from the discounted mail remains unchanged. As a result,

there has been wide acceptance of the benefits of worksharing by all types of mailers.

IV. Ways to Improve the Process.

The current leadership of the Postal Service, Postmaster General Potter and Board of Governors Chairman Fineman, are doing an excellent job of focusing on important issues: how to modernize postal processing operations to match today's mail mix; and how to foster cooperation and compromise with both postal labor and postal customers. This leadership has successfully concentrated on fixing what is wrong, rather than attempting to find outside forces to blame for Postal Service problems.

Relations between the Postal Service and the PRC are good today, and we are working together to explore ways to make the current rate process more effective. Nevertheless, over the years there have been periods of tension between the PRC and the Postal Service. It is the PRC's job to review, and when necessary expose flaws in proposals made by the Postal Service, and it therefore has been in the Service's interest to limit the PRC's role and authority. These conflicting objectives have naturally resulted in an occasionally adversarial relationship.

I suggest that this relationship has helped both organizations to function efficiently. Moreover, I believe the President's Commission should examine the balance of responsibilities between the PRC and the Postal Service, and consider whether adjustments in four specific areas might be beneficial.

(1) The PRC primarily is charged with reacting to requests from the Postal Service. It has no continuing responsibility to investigate, evaluate, or advise on matters that inevitably affect domestic mail rates. Giving the PRC authority to review and report as necessary on Postal Service efficiency and data collection would benefit all concerned.

(2) The PRC does not have authority to subpoena the Postal Service to produce existing information the PRC needs to meet its obligations under the Act. This can prevent the PRC from successfully evaluating issues properly raised in its proceedings.

(3) The PRC presently can not direct the Postal Service to collect essential information. In 1987 the PRC strongly urged the Postal Service to collect certain data necessary to accurately allocate the costs of city delivery carriers. Now, after more than 15 years and repeated requests, the over \$10 billion of annual city carrier costs still are allocated using the same data found inadequate in 1987.

Congress did not intend in 1970 to establish a ratemaking partnership in which one partner could, by inaction, frustrate the other from meeting its responsibilities.

(4) Lastly, I urge this Commission to focus on two flaws in the current complaint procedure, 39 U.S.C. § 3662. The current law allows aggrieved mailers to engage in a potentially long and expensive procedure after which they may get no relief, even if their claim is found valid.

The PRC is tasked with hearing complaints from those who believe the Postal Service is failing to provide rates or services in accordance with the law. It must provide a formal hearing, similar to a rate case, for such complaints; but the Postal Service need not act on the PRC's findings. Furthermore, aggrieved complainants do not have a clear right to appellate review if the Postal Service ignores or rejects the PRC's opinion.

In its most recent complaint case opinion, issued November 5, 2002, the PRC found that in some respects the complaint was justified. Today, more than three months later, there has been no reaction from the Postal Service.

I believe that the PRC should have authority to require appropriate changes when it finds in a complaint decision that the Postal Service is not acting in accordance with the Act. Appellate review of complaint decisions should be available to all parties including the Postal Service.

V. Conclusion.

When your Commission develops recommendations for how to improve the structure of the Postal Service, I urge it to consider both the changes that have occurred in the last 30 years, and the considerations that continue to be pertinent despite the passage of time.

First-Class Mail probably will not remain the predominant medium for business and personal correspondence. In the coming years, a significant portion of bill presentment and payments is likely to leave the mailstream. This mail has been extremely profitable to carry, and its loss will put financial pressure on the Postal Service.

First-Class letters and Priority Mail, the subclasses most likely to be affected if correspondence leaves the mailstream, currently generate over 60 percent of Postal Service revenues, but are called on to cover almost 75 percent of the Service's overhead costs. If there is significant diversion of

this mail, other mailers will face sharply increasing rates unless the Postal Service can reduce its overhead.

However, even under pessimistic scenarios, many Americans will continue to use letters to conduct their personal and business affairs. The volume of mail could shrink by 25 percent, and the Postal Service would still be carrying twice as much mail as it did 30 years ago, when the Postal Reorganization Act was passed. Americans still will need fair and reasonable postal rates. And assuming that mail service continues to be provided by a government-sponsored monopoly, mailers still will need the same protections from discriminatory or arbitrary actions that they needed in 1970.

Developing feasible solutions that balance these concerns will be difficult. I hope my comments will prove helpful. I will be happy to respond to any questions you might have, either this morning or in the coming weeks.